INDEX.

Authorities Cited.

SUPREME COURT OF THE UNITED STATES

October Term, 1946.

No. 556

CITIES SERVICE GAS COMPANY, a corporation,
PETITIONER,

vs.

FEDERAL POWER COMMISSION; PUBLIC SERVICE COMMISSION OF THE STATE OF MISSOURI; the CITY OF KANSAS CITY, MISSOURI; STATE CORPORATION COMMISSION OF KANSAS; and CORPORATION COMMISSION OF THE STATE OF OKLAHOMA, RESPONDENTS.

ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE TENTH CIRCUIT.

REPLY BRIEF ON BEHALF OF PETITIONER IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI.

The brief of respondent Federal Power Commission, resisting the issuance of writ of certiorari herein, is an artful and somewhat adroit evasion and inversion of the issues of fact and of law presented in this record.

Rarely is a litigant subjected to such high-handed disregard of both the facts and the law and to such arbitrary excess and abuse of procedures and the ordinary processes of reasoning, as are disclosed by this record, including the brief now under discussion.

The "Questions Presented," as formulated by counsel for respondent Commission *(Comm. Br., pp. 2-3)*, are cleverly

misleading and confusing, as we point out with particularity later herein. Moreover, a mere re-recital of the Commission views and conclusions *(Comm. Br., pp. 3-10)*, it appears, is expected to foreclose all issues. The almost off-hand manner in which all questions of law are brushed aside and dismissed by a sentence or a phrase actually serves to disclose the doubt and misgivings of those who prepared the document in question. The brief is neither forthright nor accurate in the summary treatment indulged as to the facts directly in issue and the law controlling.

The Right of Review.

The failure and refusal of the Court of Appeals to perform any real function of actual review whatever, as directed by *Section 19(b)* of the Gas Act[1] and required by this Court,[2] is disposed of by footnote reference as a mere incidental matter *(Comm. Br., p. 3)*. The statutory standard of "fair and reasonable," the question of "pragmatic adjustments which may be called for by particular circumstances" and the insufficiency of the evidence and the findings to support the Commission order are ignored in the Commission brief as well as by the Court of Appeals. The idea seems to be that the Commission assertion that its conclusion is "fair and reasonable" and "liberal" *(Comm. Br., p. 6)* concludes the entire matter. This philosophy of benevolence and liberality is an ever present attribute and expression of personal government. Under this theory of control, the petitioner is to be subjected to the impossible burden that it must be "conclusively shown" by it that the Commission action "will prevent the company from operating successfully as a public utility,"[3]—that is, not alone as to its regu-

---

1. "Upon the filing of such transcript such court shall have exclusive jurisdiction to affirm, modify, or set aside such order in whole or in part. * * * The finding of the Commission as to the facts, if supported by substantial evidence, shall be conclusive." See Pet. for Certiorari, p. 4, footnote 3.

2. Connecticut L. & P. Co. v. Federal Power Comm., 324 U. S. 515, 65 S. Ct. 749; Colorado-Wyoming Gas Co. v. Federal Power Comm., 324 U. S. 626, 65 S. Ct. 850.

3. Opinion Court of Appeals herein, R. V. 3, p. 1332; 155 F. 2d, 694, 701.

lated business and properties but including also its unregulated business and properties as well *(Comm. Br., p. 6)*.[4] It is not sufficient, according to the Court of Appeals, that the record disclose that the order is "unjust or unreasonable,"[5] and that it visits grievous injury or irreparable injury upon the utility. There must be actual destruction, which prevents the "utility" from functioning as such before the statutory court of review has "the right to intercede." Moreover, however deficient the record may be to support the Commission action, the burden imposed is not merely to overcome "a presumption of validity," *(Federal Power Comm. v. Hope Natural Gas Co., supra)*, but also to prove "conclusively" the resulting destruction, notwithstanding *Section 19(b)* of the Gas Act, which requires adequate findings supported by "substantial evidence." The application of any such perversion of the statute and common right, as the record herein manifests was here indulged, is administrative finality and supremacy as well over all principles, processes and agencies of government. Yet to this untenable and amazing position of the Court of Appeals in this case *(R. V. 3, p. 1332)*, the Commission now openly subscribes *(Comm. Br., pp. 12-13)*.

---

4. "Accordingly, the Commission found 'the reasonable *rate base* for the company *as an assembled whole* and an established natural gas utility' to be not more than $48,567,756 (R. I. 67-68, 50). *On that rate base, it allowed* an annual return of 6½% (or $3,156,904), which it found to be 'fair and reasonable' and 'liberal' (R. I. 68, 52)" (*Comm. Br., p. 6*). The substance of the foregoing language is to be noted. Clearly the Commission under Section 1(b) has no regulatory jurisdiction over sales other than "sales for resale," yet here it is said the Commission "allowed an annual return" on the unregulated as well as the regulated operations and business, for the "rate base" referred to embraces all properties and operations of the petitioner. This serves to illustrate the indifference and disregard by the Commission of the limits of its statutory authority.

5. Federal Power Comm. v. Hope Natural Gas Co., 320 U. S. 591, 602, 64 S. Ct. 281, 288.

ARGUMENT.

I.

Under the title heading "Production and gathering facilities" *(Comm. Br., pp. 10-13)*, counsel purport to deal with the several issues of jurisdiction over production and gathering, the rate base of natural gas reserves, and allocation, all mingled in their statement of "Questions Presented." *(Number 1, Comm. Br., p. 2.)*

It is asserted *(Comm. Br., pp. 10-11)*, quoting from the opinion of the Court of Appeals herein, that "the question of including production and gathering facilities in the rate base" has been "squarely met and conclusively decided" by this Court.[6] It is then sought by counsel to identify the issue of "fair value" of "those facilities" as a mere "alternate contention" to the question of jurisdiction over "production or gathering" *(Comm. Br., p [illegible])*. It is said the so-called "alternate contention (had been) rejected in those cases."[6]

Commission counsel make two contentions:

(1) The first *(Comm. Br., p. 11)* is that Mr. Justice Jackson, despite his specific declaration of position as to the meaning of *Section 1(b)* of the Gas Act in the *Colorado Interstate Gas Company* and *Canadian River Gas Company* combined case, *supra,* and as to the meaning of *Section 201(b)* of the Power Act (which parallels *Section 1(b)* of the Gas Act) in the *Connecticut L. & P. Company* case, *supra,*[7] nevertheless, by his concurrence in the *Panhandle Eastern Pipe Line Company* case, *supra,* "is in full accord with the prevailing view," so-called, declared by Mr. Justice Douglas and his three concurring associates in the *Canadian River Gas Company* case.

In the *Panhandle* case, on the limited review there granted that Company, the sole issue before this Court was

---

6. Citing generally, Colorado Interstate Gas Co. v. Federal Power Comm., 324 U. S. 581; Panhandle Eastern Pipe Line Co. v. Federal Power Comm., 324 U. S. 635, 648; Federal Power Comm. v. Hope Natural Gas Co., 320 U. S. 591, 606.

7. See Petition for Writ of Certiorari herein, pp. 6, 7-9, 29-30, 30-32, 47-49, 49-58.

the question of allocation. Furthermore, while Mr. Justice Douglas therein did state that the question of "inclusion of its production and gathering facilities in the rate base" was "controlled" by the *Canadian* case, he thereafter expressly excluded that question from the *Panhandle* case on the ground that *Panhandle,* not having objected to such inclusion in its petition for rehearing before the Commission, "is accordingly precluded by *Section 19(b)* of the Act from attacking the order of the Commission on the ground that they are included."[8] Counsel with equal force could have argued that the late Chief Justice Stone, despite his vigorous dissent in the *Canadian* case, nevertheless, in the *Panhandle* case was "in full accord with the prevailing view," so-called, for the official report of that case also states "Mr. Chief Justice Stone concurring."[9]

While adding a footnote *(Comm. Br., p. 11)* to explain "the concurring opinion" of Justices Roberts, Reed and Frankfurter, counsel overlooked the fact that the concurrence of the late Chief Justice Stone, and of Mr. Justice Jackson as well, must be taken to relate only to the actual and sole issue of allocation before this Court in that case.

(2) In their discussion *(Comm. Br., pp. 11-13)* supporting the exclusion by the Commission of all evidence of "fair value" of natural gas properties and reserves as "immaterial and irrelevant" *(R. V. 3, p. 1331),* counsel imply, but do not directly state, that the exclusion of such evidence in this case was not predicated upon the construction given to *Section 6(a)* of the Gas Act, as well as to *Section 208(a)* of the Power Act, by the Commission in *Detroit v. Panhandle Eastern Pipe Line Co.,* 45 P.U.R. (n.s.) 203, and in *Chicago District Electric Generating Company,* 39 P.U.R. (n.s.) 263. Based upon such implication, counsel conclude that the Commission did not misconceive "the applicable legal criteria" *(Comm. Br., p. 12).* The argument must be rested on implication because the facts of this record and the history of this case are to the contrary.

---

8. Panhandle Eastern Pipe Line Co. v. Federal Power Comm., *supra,* 324 U. S. at pages 648-649, 65 S. Ct. at page 828.

9. Panhandle Eastern Pipe Line Co. v. Federal Power Comm., *supra,* 324 U. S. at pages 650-651, 65 S. Ct. at page 829.

In this case the Commission, through its Examiner *(R. V. 1, pp. 160-166)*, and thereafter in its Opinion *(R. V. 1, pp. 31-32)*, excluded all evidence of "fair value" of all and every part of the properties, including the gas reserves of petitioner, on the theory developed by the Commission in *Detroit v. Panhandle Eastern Pipe Line Company, supra*, and *Re Chicago District Electric Generating Company, supra.* As stated, both by the Examiner and by counsel for the Commission, "the actual legitimate cost of these leases can be determined from the books," and therefore there is not presented a case in which "the exigencies of the particular situation require such a determination" of fair value *(R. V. 1, pp. 161, 163, 164, 165-166).*[10]

---

10. Following are excerpts from the objection of counsel for the Commission to the reception of any and all evidence of "fair value" of natural gas reserves and other properties of petitioner and the ruling of the Examiner sustaining the objection:

> Counsel for Commission: "I have just quoted an excerpt from Section 6(a) of the Natural Gas Act.
>
> "Now, the Commission has held that, under that section, in the absence of any showing by the company, that consideration of fair value must be given, or in the absence of any evidence that the original cost of the properties of the company can not be determined, that re-production cost evidence or evidence of so-called 'fair value' must be excluded.
>
> * * * * *
>
> "In other words, under the evidence thus far adduced it is clear that the original cost of these leases has been already ascertained by the commission's staff from the books and records, and so far as it appears in the evidence to date, it can be ascertained from the books and records of the company.
>
> * * * * *
>
> "I believe your Honor is bound by the decisions of this Commission, and I believe the Commission has spoken with respect to this matter and has received the sanction of the United States Supreme Court *in adopting the original cost formula and rejecting all others. I therefore urge upon your Honor to exclude from this case any evidence of so-called value of the gas leaseholds.*"
>
> * * * * *
>
> Trial Examiner: "Well there isn't any difference of opinion as to what the Federal Power Commission has held on the subject, is there?"
>
> Counsel for Company: "I don't think there is, no. I think they have held that value has nothing to do with it."
>
> Trial Examiner: "You are familiar with the Commission's

Additionally, the Commission witnesses, *Kenneth W. Smith*, Assistant Chief Accountant, *(R. V. 1, pp. 152-153)* and *Charles W. Smith*, Chief of the Commission Bureau of Accounts, under whose direction the various Commission exhibits were prepared *(R. V. 1, pp. 183-184, 385-387)*, declaring the viewpoint of the Commission, testified, apparently as legal experts, to the effect that it is not proper in a valuation case "under the Act" to do other than arrive at actual legitimate cost as the rate base of all properties, including natural gas reserves.

The law, according to both the Commission and its staff, requires the "cost" formula, and no other. There is no choice. No discretion is allowed to adopt any other standard for the determination of rate base, even to conform to the statutory standard of "fair and reasonable."[11] The view

---

opinion in the Chicago District Electric Generating Corporation case, are you?"

Counsel for Company: "Yes, sir."

Trial Examiner: "In which the Commission said, speaking of Section 208-A of the Federal Power Act, which is identical with Section 6-A of the Natural Gas Act, that 'this section contemplates the ascertainment of facts, other than the actual legitimate cost, which bear on the fair value of the company's property in rate-making procedures, when the exigencies of the particular situation require such a determination.'

"Is it your contention that the exigencies of the particular situation here require such a determination?"

Counsel for Company: "I would think that, if this witness would testify, for instance, that these leases are worth 20 million dollars, and the Commission's staff recommended to us $400,000 for a rate base, that that showed the cost was no element to be considered alone in determining a rate base, and that value must be given consideration where such an exigency exists."

Counsel for Commission: "I submit that that completely begs the whole question."

Trial Examiner: "It seems to me it would defeat the whole purpose or the Commission's construction, at any rate, of the language of the statute.

"There is no contention here, is there, that the actual legitimate cost of these leases can not be determined from the books?"

Counsel for Company: "No. There is no such contention, Mr. Examiner."

Trial Examiner: "Objection is sustained. You may make your offer of proof."

11. Panhandle Eastern Pipe Line Co. v. Federal Power Comm., *supra*, 324 U. S. at page 649, 65 S. Ct. at page 828.
Federal Power Comm. v. Hope Natural Gas Co., *supra*, 320 U. S. at page 602, 64 S. Ct. at page 287.
Colorado Interstate Gas Co. v. Federal Power Comm., *supra*, 324 U. S. at page 605, 65 S. Ct. at page 840.

urged is that "rate base" is fixed and limited inevitably by "cost," as a matter of law.[12] The Commission evidence, the Commission exhibits, the Commission opinion *(R. V. 1, pp. 31-32)* and the Commission order *(R. V. 1, p. 66)* so manifest and so declare.

The implication of counsel *(Comm. Br., p. 12),* that the so-called Commission finding that "no necessity was shown to exist for the consideration * * * of 'fair value' of its property" *(R. V. 1, p. 66)* indicated that in this case some sort of a selection between rate base formulas had been made, and hence the Commission did not misconceive "the applicable legal criteria," is extremely disingenuous.

The issue of "fair value" herein presented, was neither met nor decided by this Court in the *Colorado Interstate Gas Company,* the *Canadian River Gas Company,* or the *Panhandle Eastern Pipe Line Company* cases, *supra.* That issue, as the opinion of Mr. Justice Douglas in the *Canadian River Gas Company* case, *supra,* specifically states, was not presented in the limited review granted in those cases.[13]

In the case of *Federal Power Commission v. Hope Natural Gas Company, supra,* the Company there involved offered no evidence of the fair value of its gas reserves. This was pointed out by Mr. Justice Jackson in the *Canadian Rievr Gas Company* case, *supra,* (324 U.S. at 645, 64 S. Ct. at 308), and it similarly was pointed out by Judge Phillips in his dissenting opinion in this case *(R. V. 3, p. 1347).*

The Commission brief, after embracing the false thesis of the Court of Appeals that the reviewing courts "have not the right to intercede unless it is conclusively shown that

---

12. But see to the contrary: Canadian River Gas Co. v. Federal Power Comm., 324 U. S. 581, 603-604, 65 S. Ct. 829, 840, and cases cited; Federal Power Comm. v. Natural Gas Pipeline Co., *supra,* 315 U. S. at page 586, 62 S. Ct. at page 743.

13. See Canadian River Gas Co. v. Federal Power Comm., *supra,* 324 U. S. at page 605, 65 S. Ct. at page 841, where Mr. Justice Douglas, speaking for himself and Justices Black, Murphy and Rutledge, declared: "Hence we cannot say as a matter of law that the Commission erred in including the production properties in the rate base at actual legitimate cost. That could be determined only on consideration of the end result of the rate order, a question not here under the limited review granted the case."

failure to give consideration to the fair value of properties, including the valuable leasehold estates, will prevent the company from operating successfully as a public utility" *(Comm. Br., pp. 12-13)*,[14] indulges distortion, speculation and conclusions *(footnote 5, page 13 of the brief)* predicated on the theory of Commission benevolence and liberality. Among other things, in seeking to evade and gloss over the nonsensical and "delirious" consequences of the application of the Commission rigid "cost" formula to natural gas reserves *(Pet. for Certiorari, pp. 8, 24-26, 56-58)*, it is said "The comparison also omits from the figures for the cost of produced gas the expenses of exploration and development * * *." This is not true. The comparison was based on Commission exhibit 30 *(Pet. for Certiorari, pp. 24-26, 56-58)*. Reference to that Commission exhibit *(R. V. 3, p. 1200)* discloses that "exploration and development costs" were not omitted. The direct implication from the closing sentence of the footnote: "The Commission's allowance of $295,439 for such exploration and development costs *(R. I, 57, III, 999, 963)* is the equivalent, when capitalized at 6½%, of an additional $4,500,000 in the rate base," is that such allowance of *actual expense* was a matter of grace and generosity on the part of the Commission. As a matter of fact if such allowance were not a proper expense allowance under the Act, the Commission had no lawful authority to allow it, either as to produced or purchased gas. The same is true of other production "expenses." The footnote pointedly reflects the attitude and action of those who conceive themselves to be possessed of an uncontrolled but always a benevolent "discretion."

II.

Under the subject title "Existing depreciation and depletion," Counsel *(Comm. Br., pp. 13-15)* presumably would deal with Question Presented, number 2, which they state to be "whether the Commission's subsidiary finding, in regard to existing depreciation, that 'a qualified staff engineer inspected the company's properties * * *,' was supported by substantial evidence" *(Comm. Br., p. 2)*. In fact, the discus-

---

14. See Pet. for Certiorari and Supporting Brief, pp. 3-6, 7-9, 41-46, 47-58.

sion of counsel is not responsive to the question as posed by them, since the record discloses affirmatively and conclusively from the evidence of the Commission itself that the "finding" in question is not supported by but contrary to the evidence *(Pet. for Certiorari, pp. 9-11, 58-62).* Counsel do not even assert that it is supported by the record *(Comm. Br., p. 14).* However, in order to discount and by-pass it, the discredited finding is characterized by counsel as "a subsidiary finding." Thereupon counsel, as did the Court of Appeals *(R. V. 3, pp. 1333-1335),* argue that for various reasons, none of which is reflected in the Commission so-called findings,[15] "inspection" of the pipeline system, which constituted 70% of the Commission total rate base *(Comm.*

---

15. It is claimed by counsel among other things (*Comm. Br., p. 15*) that "the witness inspected reclaimed pipe," the idea being this was a valid substitute for inspection of any part of the 4300 miles of the pipeline system, which the Commission found he inspected, but which admittedly he did not inspect even to the extent of one length of pipe. He testified that he examined "reclaimed pipe in the Company's 'storage yards.'" In these yards "the pipe as it is reclaimed from the pipeline system is graded and sorted in the pipe storage yards, and racked, and as the occasion arises for its re-use it is reconditioned." The purpose of making inspections of pipe in these yards, the witness testified, is "to determine the action of the erosive elements that are in the soil on the pipe, to make a study of corrosion and the amount of deterioration of pipe which has been in the soil for a period of years. * * * It gives us some idea" of the Company's retirement policy (*R. V. 1, pp. 438-439*). The witness of course could not know, and did not testify that he did know, anything whatever about the previous history of the particular sections of pipe which he examined, all as graded, sorted and racked in the storage yards. The witness had no records of pipe in stock in storage yards (*R. V. 1, p. 489*). He simply examined various sections of pipe without any information whatever as to where, how long and under what soil and other conditions the pipe had been used. Nor did he know whether the pipe had been retired from service because of deterioration or for other reasons.

The "2020 pipe inspection reports" referred to had nothing whatever to do with "a service life study." They simply embodied observed facts of the then condition of pipelines by the examining company engineers. The reports did not embody or disclose the conclusions of such engineers as to the then condition of the pipelines (*R. V. 1, p. 527*).

The Company's rates of depreciation, not based upon "cost" of plant, had been altered frequently during the years prior to 1941 (*R. V. 1, pp. 518, 557-558*). The fact that "presently," that is, in 1941, (*Comm. Br., p. 15*) the rates embodied in Commission Exhibit 12 for the most part were those then in use by the Company but were applied to a totally different valuation base of its properties, leaves counsel's contention without logical bearing or consequence.

Counsel for the Commission are far too able and penetrating in their understanding not to know that the superficial explanation offered by them is without substance, and therefore advanced to evade the real issue, the insufficiency of the record to support the Commission discredited finding, which in no sense is "subsidiary." It is foundational but not true.

Ex. 5, pp. 977-978; R. V. 1, p. 50), was not necessary. (See *Pet. for Certiorari, pp. 58-61)*. The Commission "finding" under consideration (quoted at *pages 9-10, Pet. for Certiorari)* is predicated on the testimony of the *sole* Commission witness on depreciation *(R. V. 1, pp. 427-430)*. That witness undertook to lay the foundation for Commission Exhibit 15 entitled "Services Lives and Annual Depreciation Rates." This exhibit *(R. V. 3, pp. 1127-1141)* it is said embodies a factual determination of the elements of depreciation, both physical and functional *(R. V. 1, p. 427)*. The exhibit was adopted and relied upon in Commission Exhibit 12, entitled "Annual and Accrued Depreciation" *(R. V. 3, pp. 1039-1088)*. See Schedule 1 *(R. V. 3, p. 1039)* and Schedule 2 *(R. V. 3, p. 1042)* thereof. The Commission thereafter in its opinion and order proceeded in reliance upon these two correlated exhibits *(R. V. 1, pp. 44, 45, 47, 67, 68)*.[16]

The unsupported Commission "finding" *(R. V. 1, p. 44)* is the only portion of the Commission's argumentative treatment of the matter *(R. V. 1, pp. 43-48)* which even purports to deal with "*existing depreciation*" as a fact. That "finding" of course was required to support and give authority to Commission Exhibit 15.[17] That exhibit in turn was essential as a foundation to any actual or purported determination of "existing depreciation" by the Commission *(R. V. 1, pp. 43, 47)*. This is perfectly obvious from the rec-

---

16. In the Commission opinion it is said: "The depreciation rates recommended by the staff in computing both the annual depreciation expense and the reserve requirement (accrued depreciation) were derived from the average service lives of the various classes of property owned by the Company."

(*R. V. 1, p. 45*)

17. The Commission depreciation engineer (*R. V. 1, p. 72*) on direct examination testified specifically as to the purpose of field inspection and examination:

> "The purposes of the field examination were to observe, when possible, the extent to which physical deterioration had occurred; observe the measure of protection afforded to depreciable property by maintenance; determine the actual existence of the items of property as shown in the inventory and property records of the company; observe any conditions which would affect judgment based on previous experience in the determination of service life; become familiar with the operating records at their origin; become acquainted with local conditions; determine the used and useful nature of the units of property and the proper classification of such property."
>
> (*R. V. 1, p. 430; R. V. 3, pp. 1127-1128*)

ord evidence and exhibits above referred to the attention of the Court.

III.

Under the heading "Profits from Extraction Operations" *(Comm. Br., pp. 15-18)*, Counsel do not meet the issue involved in this record and presented by the Petition for Certiorari *(pp. 11-13, 33, 62-66)*. The question is: Whether the Commission lawfully may exercise rate-regulatory authority over the separate and independent natural gasoline extraction plants of Cities Service *Oil* Company, and the operations thereof, precisely the same "as if they (such plants and operations) belonged to this petitioner," which they do not?

Number 3 of the "Questions Presented," as adroitly framed by Commission counsel *(Comm. Br., p. 2)*, indicates that the issue is simply whether the Commission in this rate case may inquire into the reasonableness of contracts between this petitioner and an affiliate, Cities Service *Oil* Company. This concededly the Commission may do. Counsel's entire discussion distorts and evades the uncontroverted facts of this record *(Pet. for Certiorari, pp. 11-12, 62-66)*. They are careful not to state the fact that the Commission exercised direct rate-regulatory control over, and conducted a rate case as to, the *Oil* Company's plants and operations in question "and a 6½% return was allowed on the investment rate base of the Oil Company" *(Comm. Opinion, R. V. 1, p. 53)*. No finding or other reference of any kind to this procedure is to be found in the Commission Findings and Order *(R. V. 1, pp. 66-70)*.

This procedure counsel assert *(Comm. Br., p. 17)* "is no more regulation of the gasoline extraction business than the Commission's use of data relating to production and gathering constitutes regulation of those activities," citing the *Natural Gas Pipeline Company*, the *Hope Natural Gas Company*, the *Colorado Interstate Gas Company*, the *Canadian River Gas Company*, the *Panhandle Eastern Pipe Line Company* cases, *supra*.

It should not be necessary now to answer such a contention. That contention was rejected in the *Canadian River*

Gas Company case, *supra.* There eight Justices of this Court declared themselves to the effect that the inclusion of the production and gathering properties of Canadian Company in the Commission "cost" rate base was *in fact* the exercise of rate-regulatory jurisdiction over such properties and facilities. Four of the Justices, speaking through Mr. Justice Douglas, so construed the Natural Gas Act as to enable them to conclude that the Commission had lawful authority and jurisdiction so to do.[18] Four of the Justices, speaking through the late Chief Justice Stone, were emphatic in their conviction that, while the inclusion of such properties and facilities in the utility rate base was *in fact* rate-regulatory control, there was no authority in the law for the exercise of such a control.[19] Mr. Justice Jackson took the position that the inclusion of the production or gathering facilities in the rate base did not constitute "direct regulation upon that activity" which would have "exceeded its jurisdiction," but amounted merely to inquiry and examination of conditions and events quite beyond the regulatory control of the Commission where they are thought to affect the cost of that which the Commission is directed to determine.[20] The view of Mr. Justice Jackson was not accepted by the remaining members of this Court. Moreover, as yet there has been no "authoritative determination" by a majority of this Court on "the principles of law involved" in connection with the determination of the question of jurisdiction of the Commission over "The production or gathering of natural gas."[21]

In the case of *United Fuel Gas Co. v. Commission,* 278 U.S. 300, 321, 49 Sup. Ct. 150, 156, cited by counsel *(Comm. Br., p. 17),* the net return derived from the process of extracting natural gasoline from natural gas was apportioned by the State Commission and the Supreme Court of West

---

18. Canadian River Gas Company v. Federal Power Comm., *supra,* 324 U. S. at pages 597-604, 65 S. Ct. at pages 837-840.

19. Canadian River Gas Company v. Federal Power Comm., *supra,* 324 U. S. at pages 615-625, 65 S. Ct. at pages 845-850.

20. Canadian River Gas Company v. Federal Power Comm., *supra,* 324 U. S. at pages 608-615, 65 S. Ct. at page 842.

21. Pet. for Certiorari, pp. 6, 47-49.

Virginia at the ratio of 50% to each of the two affiliates, one of which had been organized for the express purpose of taking over most of such profits. This division the Supreme Court of the United States approved, declaring it was conformable to evidence in the record, showing that the Commission order actually reflected "dealing at arm's length." The implication of counsel that the Commission here so proceeded is not true. Here the Commission treated the *Oil* Company and the *Gas* Company as one company *(R. V. 2, p. 792)* and made no effort whatever to adjust the contract arrangement on the basis of "arm's length dealing" *(R. V. 2, pp. 798, 802)*. All net return from the extraction operation averaged for the years 1939-1941 was divided, $380,000 to the *Gas* Company and $43,784 to the *Oil* Company, a ratio in excess of 8 to 1. Under this Commission fixation the $43,784 allowed to the *Oil* Company *ostensibly* represented 6½% return upon the Commission rate base imposed on the extraction properties of the *Oil* Company *(R. V. 1, p. 54)*. This was on the theory that all earnings in excess of 6½%, even from unregulated business, are non-permissible "excess earnings" *(R. V. 2, p. 800)*, a legal assumption *constantly* indulged by Commission, its staff and counsel.

The contention made by counsel *(Comm. Br., p. 17)* as well as by the Court of Appeals, to support the Commission exercise of direct rate-regulatory control over the gasoline extraction plants and operations of the *Oil* Company, that otherwise a regulated gas utility would be enabled "to syphon off profits to nonregulated affiliates," does not stand up. Heretofore, in many cases and as a matter of established procedure, commissions and courts alike, *without attempting to exercise regulatory control over the nonregulated affiliate,* have made inquiry into and required that the contractual relations between affiliates be reasonable and equivalent to "arm's length dealings."[22]

---

22. Smith v. Illinois Bell Tel. Co., 282 U. S. 133, 51 S. Ct. 65.
United Fuel Gas Co. v. Railroad Comm., *supra*.
See, dissenting opinion, Chief Justice Stone, in Canadian River Gas Company case, *supra*.

IV.

The discussion by counsel *(Comm. Br., pp. 18-20)* of the disallowance of *all* Federal income tax as an item of expense, as an element of cost of service, and from the cost of service allocation, is not in conformity either with the facts of this record, the law generally or in conformity with any announcement in the *Canadian River Gas Company* and *Colorado Interstate Gas Company* cases, *supra.* The Commission theory of disallowance was not applied in either the *Canadian River Gas Company* or *Colorado Interstate Gas Company* cases, *supra.*[23] That theory is that, for Federal income tax purposes, the Commission may limit the petitioner's earnings upon both the regulated and the unregulated business to 6½% on a "rate base" embracing *all* property, unregulable as well as regulable *(R. V. 1, p. 57; Comm. Br., pp. 6, 18; R. V. 3, p. 1337).* If upon such a tax base no Federal income tax theoretically would result according to Commission computation, then no allowance for such taxes *actually* accruing need be made by the Commission.[24] The Commission has no authority to set up any such tax base. Nor does the Commission have any lawful authority for the purposes of tax computation or otherwise to place a 6½% or any other limitation upon the earnings of the unregulated business.[25] Federal income tax is determined by the taxing authorities, and under the revenue laws, with reference to the business as a whole, as pointed out by Judge Phillips in the Court of Appeals *(R. V. 1, p. 1349).* Such a computation of Federal income tax was made by the Commission staff *(Comm. Ex. 41, R. V. 3, pp. 1264-1265).* In that computation all expenses and deductions, applicable alike to the regulated and unregulated business, are reflected and included. Such has been the pro-

23. See opinion Mr. Justice Douglas, 324 U. S. at page 587; 65 S. Ct. at page 832.

24. That such is precisely the Commission position is also clear from the assertion of counsel (Comm. Br., p. 18) that "* * * if petitioner made no more profit on its *non-regulable* than on its regulable business there would be no such tax liability to be allocated."

25. See Panhandle Eastern Pipe Line Company case, *supra*, 324 U. S. at pages 641-642, 65 S. Ct. at page 825; Colorado Interstate Gas Company case, *supra*, 324 U. S. at pages 586-589, 65 S. Ct. at pages 832-833.

cedure *which the Commission heretofore purported to follow* in its so-called "cost of service allocation," which is developed from cost of service, which, in turn, has its foundations in all expenses and deductions chargeable against gross income, including Federal income taxes. The results, whatever figures are paraded by Commission counsel in their now offered exhibit *(Comm. Br., p. 20. footnote 10)* reflect *all* expenses and deductions attributable to both the regulated and the unregulated business, except in this particular instance Federal income taxes. It is perfectly obvious that had that portion of the expenses and deductions attributable to the unregulated business been excluded, the Federal income tax conclusions of Commission staff and counsel *(Comm. Br., pp. 19-20)*, would have been vastly different. Counsel in fact take advantage of *all* expenses and all other deductions *in full*, to arrive, through mathematical mechanics, at a result which they assert "clearly wipes out that taxable income" on the regulable business *(Comm. Br., p. 20)*. The *undefined* "statutory tax deductions" which we are told *(Footnote 13, Comm. Br., p. 20)* "would relieve petitioner of income tax liability even though for rate purpose it earned 6½% return," of course relate to petitioner's business *in its entirety*, regulated and unregulated. Here again we gain an insight into the Commission's theories and related practices of disallowance of expense and allocation of cost.

Counsel's computation *(Comm. Br., pp. 19-20)* proves far too much. They find themselves obliged to offset taxable income, which they state is allocable to regulated business, with the rate reduction order itself. Their statement in that behalf is, "The net income of the regulable business ($7,614,407) is *roughly* 79% of the total net income ($9,550,793) of the entire business. 79% of petitioner's taxable income for 1941 ($6,057,181) is *$4,829,390*; this represents the taxable income allocable to regulated business, and the corresponding rate reduction *($5,499,655)* clearly wipes out that taxable income" *(Comm. Br., pp. 19-20)*. Thus, under the Commission order of rate reduction by the accounting and mathematical devices indulged by counsel, the so-called taxable income allocable to regulated business is wiped out entirely and appears as a red figure, $670,275.

Petitioner does not concede as suggested by counsel *(Comm. Br., p. 19)* "that if it earned no more than 6½% on the *over-all rate base,* there would be no federal income tax liability." Clearly there is no method by which such a computation and ascertainment could be made, without segregating revenue, expenses and other deductions as between a return of "6½% *on the over-all rate base*" and return on the unregulated business in excess of 6½%. There is nothing of the kind in the record.

It is also asserted by counsel *(Comm. Br., p. 19)* that if a federal income tax liability "should have been included in cost of service," petitioner would not recognize that "any such tax liability would be allocable to the non-regulable business." The meaning of this language is vague and ambiguous. However, petitioner's position is that Federal income taxes should be allocated as between the regulable and non-regulable business, so that each class of the business shall bear its fair share of the costs, of which Federal income taxes is one.[25]

The statement is made also that petitioner's computation of Federal income tax *(Pet. for Certiorari, pp. 13-14)* is erroneous because "the amounts of $380,000 and $65,000 are added to the petitioner's net taxable income" *(Comm. Br., p. 19, footnote 9)*. The only Federal income tax computation in the record is Commission Exhibit 41 *(R. V. 3, pp. 1264-1265)*. This exhibit, which petitioner followed in its computation, Commission counsel now find it necessary to repudiate.

V.

Commission counsel are quite in error in their assertions and unsupported conclusions as to "Cost of service allocation" *(Comm. Br., pp. 3, 20-21)*. This petitioner does not agree with the so-called general "demand and commodity method" of allocation as differently applied by the Commission in each case to suit its own purposes. Nor does petitioner agree there is anything in this record from which the actual processes of so-called "Allocation of cost of service" are so disclosed that they can be tested by this Court or any other court, either as to "the governing considera-

tions of fairness" or as to "the judgment factors" which presumably guided the Commission. For example, the footnote under the topic "Federal income taxes" *(Comm. Br., pp. 19-20, footnote 10)* manifests the insufficiency of the Commission findings on the matter and manner of allocation, in which, of course, the prior disallowance of "expenses" and disposition of revenue," such as Federal income taxes and revenue from natural gasoline extraction operations, is basic and foundational.

It is said *(Comm. Br., pp. 19-20)* that the net income of the regulable business is "*roughly* 79% of the total net income." There is no disclosure in the Commission opinion, nor in any Commission exhibit, to that effect. The allocation procedures of the Commission, being as they are, counsel were forced to develop their own exhibit *(Comm. Br., pp. 19-20, footnote 10)*.[26] Moreover, nothing is disclosed, "roughly" or otherwise, as to the proportion of petitioner's properties devoted to the regulated business and that devoted to the unregulated business. The lack of forthrightness and clarity is patent. The Commission discloses the *actual* operation and effect of its processes of allocation only when necessary to defend its course of action. The entire subject of Commission allocation cries aloud for judicial supervision, review and correction.

"Allocation of costs," so-called, is "not a matter of the slide rule" and is not governed by "mere mathematics" or accounting theories or processes. "It involves judgment on a myriad of facts" and "considerations of fairness * * * govern." "The appropriateness of the formula * * * in a given case raises questions of fact * * *."[27] This, of course, means that the *precise* formula must be clear and specific. It also means that the application thereof in the particular case

---

26. The same type of device was indulged by Commission counsel in *Colorado-Wyoming Gas Co. v. Federal Power Comm., supra,* in the Commission brief before this Court, in an attempt to point out the allocation path which the Commission claimed it followed in that case. The exhibit of counsel in that case was designated Appendix B of the brief. The purpose of that exhibit, as the exhibit here (*Comm. Br., pp. 19-20 and footnote 10*), was to make *some* disclosure to this Court as to the Commission procedure, not apparent from the opinion and order of the Commission.

27. Canadian River Gas Co. v. Federal Power Comm., *supra,* 324 U. S. at pages 586-591, 65 S. Ct. at pages 832-834.

must be disclosed, that is, the *prior* disposition of "expenses" and "revenue," in the "cost of service" fixation. This disclosure is as important as, and in some cases more important than, the apportionment in the *final* "allocation of cost of service." The propriety of the Commission "allocation," both in principle and in application, is for examination and review in each case, to insure that it is not "unfair" and does not "transgress the jurisdictional lines which Congress wrote into the Act."[28] To decide these vital questions, as well as to determine whether the path which the Commission claimed to have followed can be discerned by any other than a seer, it is essential that the court of review enter into and discharge its function and statutory duty of judicial review. This the Court of Appeals refused to do *(R. V. 3, p. 1339)*. As to this, Commission counsel are silent.

CONCLUSION.

The record, the applicable statutory law, the decisions of this Court and the Commission brief herein, all show that the rights of this petitioner have been ignored and disregarded by Commission and Court of Appeals alike. Unless this petition for certiorari is granted and a full review allowed, arbitrary, capricious and lawless action of an administrative agency will be sanctioned.

Respectfully submitted,

DONALD C. MCCREERY,
PAUL W. LEE,
GEORGE H. SHAW,
WM. A. BRYANS, III,
CHARLES J. KELLY,
1217 First National Bank Bldg.,
Denver 2, Colorado,
Attorneys for Cities Service Gas Company, Petitioner.

GLENN W. CLARK, General Counsel,
Cities Service Gas Company,
First National Bldg.,
Oklahoma City, Okla.
Of Counsel.

---

28. Panhandle Eastern Pipe Line Co. v. Federal Power Comm., *supra*, 324 U. S. at pages 641-642, 65 S. Ct. 825.